Commentary on the August 2018 CKGSB BCI

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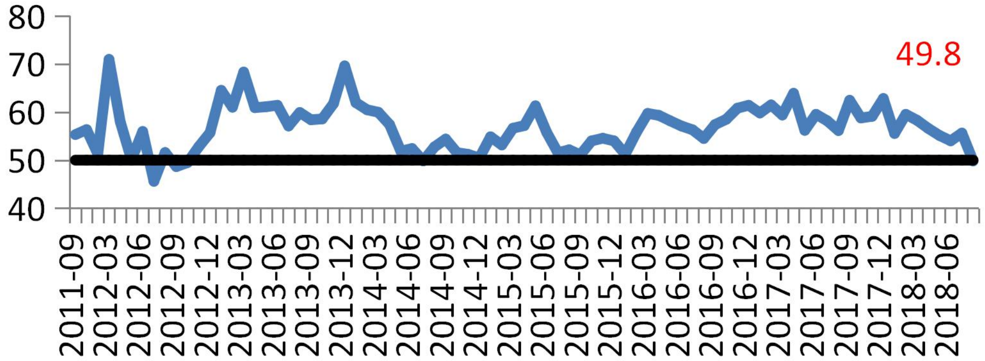
It may be that looking back, this month's CKGSB Business Conditions Index (BCI) will have added significance.

In August, the CKGSB Business Conditions Index (BCI) fell to 49.8, a major drop from last month's 55.6 (Figure 1). The last time the index breached the confidence threshold was in July 2014 (49.8).

Figure 1 Business Conditions Index (BCI)



Source: CKGSB Case Center and Center for Economic Research

Recent months have seen dramatic macro-economic changes in China. For much of the first half of 2018, a range of policies have had the effect of contracting the economy. These have included strict real estate regulations, controls over local debt, and a campaign to clean up shadow banking. And now, into this already tense environment has been thrown an escalating US-China trade war. China's current account surplus as a percentage of GDP may not be high, but its exports as a percentage of GDP are, and the US is China's largest and single most important trading partner. Its demand for Chinese products is something other trading partners will be hard pressed to replace. If this trade war continues, the negative impact on China's economic development will be noticeable, at least in the short run.

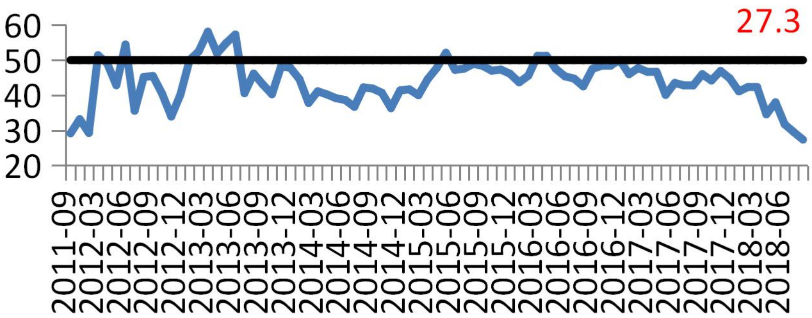
With the outcome of these domestic policies been seen for the first time, it has become clear that China's economy is cooling. The external trade war has now added another factor into the mix, increasing the kind of pressure that leads to economic downturn. This is why, while China has nominally kept up pressure on the real estate sector through regulation, it has also intensified infrastructure spending and again loosened monetary policy. The planned large scale deleveraging campaign has in reality been cancelled. Remarkably, Sheng Songcheng, advisor to the central bank and former head of the statistics department, wrote that one reason why shadow banking could not be wiped out altogether is because it remains the necessary lifeblood of SMEs. In overall terms, China has turned again to stimulus policies to prop up economic development.

Until last month, BCI data has remained relatively stable, but this month, the statistics show signs of "instability." The indices for which is this most clear will be discussed below:

August's overall BCI fell sharply, and its four sub-indices all showed significant decline. The corporate sales index fell from 78.5 to 72.0, and the corporate profit index fell from 69.3 to 60.4. Although these two worsening scores cannot be ignored, they are still fairly high, at over 70 and over 60 respectively. They are not nearly as anxiety-inducing as the latest financing and inventory indices.

The corporate financing index dropped to its lowest ever point this month, at only 27.3 (Figure 2). The declining trend has clearly been going on for a while for sampled companies to be struggling this much. Long starved of financing options, the situation is now serious.

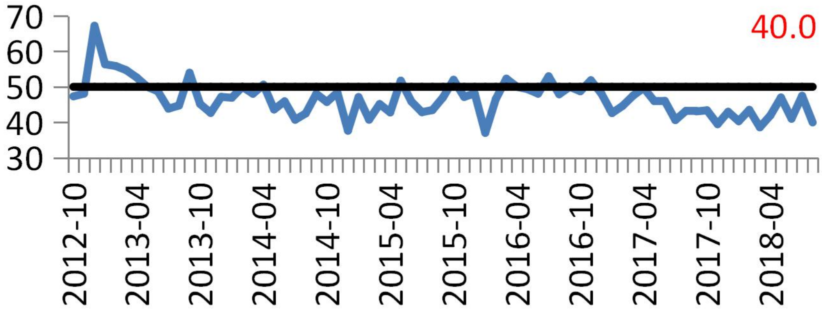
Figure 2 Corporate Financing Index



Source: CKGSB Case Center and Center for Economic Research

The inventory index continued on its downward trajectory the month (Figure 3), registering just 40.0 this month (47.5 in July). It has not yet sunk below its historical lowest point, but has been languishing below the confidence threshold for several years, meaning that firms are gotten used to holding on to far more goods than is healthy for them.

Figure 3 Inventory Index



Source: CKGSB Case Center and Center for Economic Research

The BCI sales, profit, financing and inventory indicators have all worsened, and businesses are not having a good time of it in general these days. Under such circumstances, surely cost pressures would have reduced? According to our data, there is little sign of it:

Figure 4 Labor Costs Index

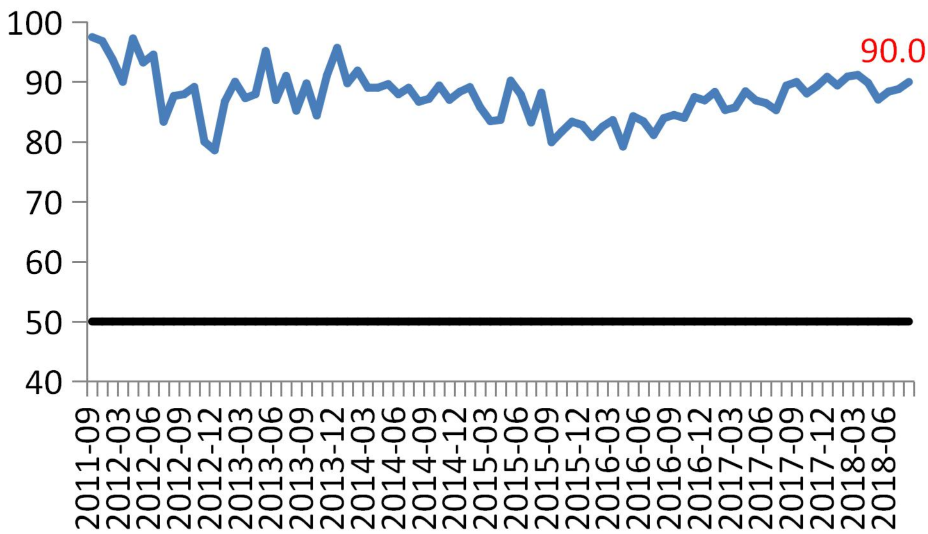
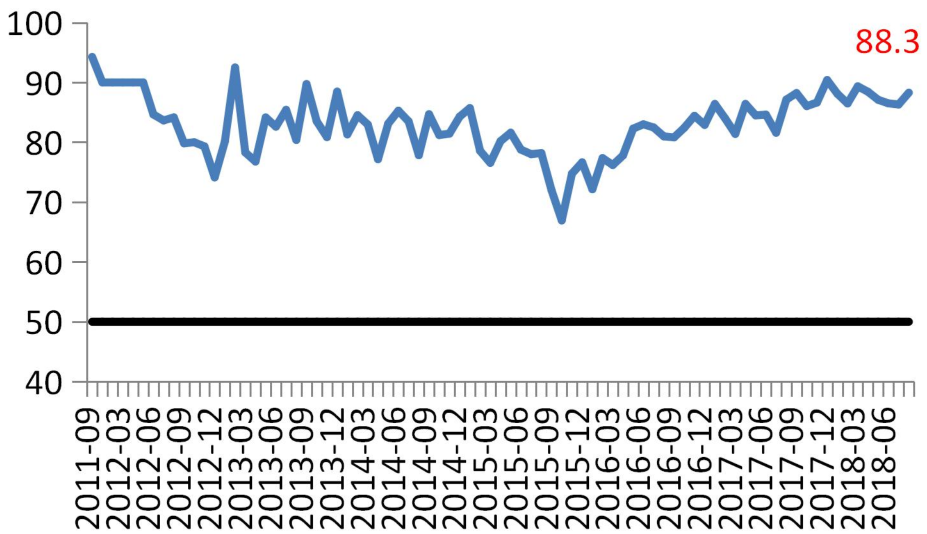


Figure 5 Overall Costs Index



Source: CKGSB Case Center and Center for Economic Research

The labor cost index rose from 88.8 in July to 90.0 this month, and overall costs are expected to rise, with the index registering 86.3 in July, rising to 88.3 in August. Given the circumstances, as costs are not going down, it appears that these pressures faced by companies are structural rather than cyclical.

As enterprises are faced with so many difficult operational issues, can they transfer some of their costs to downstream businesses or consumers through producer price increases? Our data shows that companies can do so to some degree, but face limitations. The two indicators of this are the consumer price index that fell from 71.4 last month to 67.3 this month, and the producer price index that rose from 52.8 to 55.9.

The above indices show that enterprises are under enormous pressure on the costs side, at the same time that sales and profit are expected to fall. From an supply chain angle, increased inventory means that some companies' products are not being moved through the supply chain, and may not be sold to consumers, building up in storerooms across the country. This takes up resources and is not being converted into sales, so the pressure on cashflow increases. With poor financing opportunities to start with, once a company's products lose liquidity, this really worsens the impact on the entire resource chain. From this perspective, we are worried about economic prospects in the upcoming period. If no effective measures are taken to prevent it, the most dynamic companies in China's economy, and the ones that employ the most people, are likely to face mounting challenges.

This is the author's commentary on the CKGSB BCI report for August 2018. Do not hesitate to contact the BCI team by email as shown in the accompanying BCI data report.

CKGSB Professor Li Wei
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